CHAPTER 3

FAIR AND NEUTRAL TAXATION

Part A. Excluded Sources of Income--Fringe Benefits

Current Law

An employee is generally required to include in gross income all compensation received during the year from his or her employer, regardless of whether the compensation is paid in cash or in property or other in-kind benefits. Current law, however, exempts from taxation certain employer-provided in-kind benefits, such as the cost of group-term life insurance (up to $50,000), educational assistance, accident and health insurance, group legal services, and dependent care assistance. These and certain other fringe benefits are expressly excluded from an employee's taxable income if provided under qualified employer-sponsored plans.

Reasons for Change

Compensation paid in the form of in-kind benefits is not different in principle from compensation paid directly in cash. The employee who receives fringe benefits is not in a different pre-tax economic position than the employee who receives cash compensation and uses it to purchase the same benefits. The exclusion of certain fringe benefits from income under current law is thus unrelated to the proper measurement of income. It is intended instead to reduce the after-tax cost of certain goods or services and thereby to subsidize consumption of such items by eligible taxpayers.

Assume, for example, that an employee in a 40 percent marginal tax bracket is given the choice of receiving $500 in cash compensation or $500 in personal legal services that qualify as a nontaxable fringe benefit. If the employee were required to purchase the same services directly, their $500 cost might well outweigh their value to the employee. Since the after-tax value of the $500 cash compensation is $300, however, the effective cost to the employee of the legal services, as a nontaxable benefit, is also $300. As a consequence, the employee may well decide to take the legal services, even though their value to the employee may be less than their market cost and the employee would not purchase them directly.

A government subsidy for a good or service may be appropriate where consumer demand for the item does not reflect its social value or the social cost of failing to provide it. Thus, existing policies to ensure retirement security and essential health care may justify certain tax or direct incentives to encourage employers and employees to provide for these items. Increasingly, however, tax-favored fringe benefit treatment has been extended to nonessential employer-provided benefits for which no external incentive is necessary or appropriate.

The use of the tax system to subsidize employee consumption of these nonessential benefits is unfair to taxpayers generally, reduces economic efficiency and forces higher than necessary marginal tax rates.

The tax-free character of fringe benefits causes employees to overconsume these benefits relative to their actual desire or, in many cases, need for them. Such overconsumption distorts the allocation of resources and raises prices for the services available in nontaxable form. The spiraling costs of health care in recent years may be attributable in significant part to overconsumption of health care by employees for whom such care is not only tax free but, in many cases, available without limit. The costs of such price distortions are distributed throughout the economy and affect all taxpayers. They fall most cruelly upon those who do not receive employer-provided health care and other fringe benefits but must pay for such services out of their own pockets.

The exclusion of fringe benefits from income is also inconsistent with the tax system's principles of horizontal and vertical equity. Taxpayers not working for employers with qualified benefit plans must purchase goods or services such as term life insurance or legal services with after-tax dollars. In contrast, taxpayers receiving the same goods as fringe benefits in effect purchase them with pre-tax dollars. As a result, two taxpayers with identical economic incomes may pay significantly different amounts in taxes depending on the proportion of income that each receives in the form of fringe benefits.

The unequal distribution of fringe benefits has caused some to conclude that they should be made even more broadly available. This approach would only exacerbate the distortions and revenue costs of existing law, and it would remain seriously unfair to lower income taxpayers. Under the progressive rate structure, an exclusion from income yields a greater tax benefit to a high-bracket taxpayer than to a low-bracket taxpayer. Thus, even if all taxpayers received the same amounts of non-taxable fringe benefits, the exclusion of such benefits from income would still provide a disproportionate benefit to higher income taxpayers.

A final and most serious consequence of the current exclusion of fringe benefits from income is the resulting erosion of the tax base. As the base of taxable income narrows, the rates of tax on nonexcluded income must increase in order to maintain the same level of revenue. The percentage of total compensation paid as fringe benefits has grown significantly in recent years, as employees and employers have understandably responded to the tax system's incentives. This shrinkage of the tax base must be reversed before meaningful reductions in tax rates can be achieved.

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Proposal

The exclusion of most statutory fringe benefits from income would be repealed. The current exclusion of employer-provided health care would be retained subject to limits on the maximum amount of such insurance that could be provided tax free. These proposals are described in greater detail in the following sections. See also Ch. 17 regarding the tax treatment of individual and employer retirement savings plans.

LIMIT EMPLOYER-PROVIDED HEALTH INSURANCE

General Explanation

Chapter 3.01

Current Law

All employer contributions to health insurance plans on behalf of an employee are excluded from the employee's gross income, regardless of the cost or extent of the coverage. The same rule generally applies to amounts paid by an employer to or on behalf of an employee under a self-insured medical plan.

Although medical expense reimbursements under a self-insured plan must be provided on a nondiscriminatory basis to be excludable, similar benefits provided through an outside insurer are not subject to nondiscrimination rules.

Reasons for Change

As with other tax-free fringe benefits, the exclusion of employer-provided health insurance from income subsidizes the cost of such insurance for eligible taxpayers. Within limits, this tax-based incentive for employee health insurance is an appropriate part of the national policy to encourage essential health care services. In its present unlimited form, however, the exclusion provides disproportionate benefits to certain taxpayers, encourages the overconsumption of health care services, and contributes to higher than necessary marginal tax rates.

The exclusion from income of employer-provided health insurance is unfair to individuals who are not covered by employer plans and who must therefore pay for their health care with after-tax dollars. Table 1 illustrates the impact of the exclusion on two employees each of whose compensation costs his respective employer $35,000. Individual A receives $2,400 of his compensation in the form of employer-provided health insurance; Individual B receives all of his compensation in cash. As a result, both employees receive the same level of compensation, but A's after-tax income is $809 higher than B's, simply because some of his compensation is in the form of health insurance. B must pay for any medical expenses or privately purchased insurance out of his lower after-tax earnings.

Because many employer-provided plans are so generous that the employees pay very little, if anything, out-of-pocket for health services, the employees are more likely to overuse doctor and hospital services and medical tests. The tax system subsidizes this overuse by reducing the effective cost of employer-provided insurance. As Table 1 demonstrates, A receives $2,400 in health insurance at a cost of only $1,591, since his taxes fall by $809. The rapid increase in the cost of health care services in recent years can be attributed at least in part to overconsumption of such services by employees for whom they are tax free and, in many cases, available without limit.

The unlimited exclusion for employer-provided health care has also contributed to the erosion of the tax base and to consequent high marginal tax rates. Compensation paid in this nontaxable form has grown significantly in recent years. Imposing reasonable limits on the amount of health care available tax-free is an important part of the effort to broaden the base of taxable income and reduce marginal tax rates.

In addition, the tax benefits provided for employee health care should not be available on a basis that permits discrimination between high- and low-paid employees. Thus, nondiscrimination rules should apply to employer-provided health benefits regardless of whether such benefits are self-insured or provided through third-party coverage.

Table 1

Tax Benefits Arising from the Exclusion of Employer-Provided Health Insurance 1/

	Individual A	Individual B
Total Employer Cost	$35,000	$35,000
Non-Taxable Employer-Provided Health Insurance	$ 2,400	$ ---
Employer Social Security Tax	$ 2,147	$ 2,305
Cash Wages	$30,453	$32,695
Employee Income Tax	$ 2,996	$ 3,489
Employee Social Security Tax	$ 2,147	$ 2,305
After-Tax Income Plus Value of Health Insurance	$27,710	$26,901
Cost of $2,400 of Health Insurance	$ 1,591	$ 2,400
Average Cost Per $1 of Health Insurance	$ 0.66	$ 1.00

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1/ 1985 tax rates for a family of four with no other income and with itemized deductions equal to 23 percent of adjusted gross income.

Proposal

Employer contributions to a health plan would be included in the employee's gross income to the extent they exceed $70 per month ($840 per year) for individual coverage of an employee, or $175 per month ($2,100 per year) for family coverage (i.e., coverage that includes the spouse or a dependent of the employee). These monthly dollar limits would be adjusted annually to reflect changes in the Consumer Price Index.

With respect to any employee, an employer's contribution to a health plan would be the annual cost of coverage of the employee under the plan reduced by the amount of the employee's contributions for such coverage. The annual cost of coverage with respect to an employee would be calculated by determining the aggregate annual cost of providing coverage for all employees with the same type of coverage (individual or family) as that of the employee, and dividing such amount by the number of such employees.

The annual cost of providing coverage under an insured plan (or any insured part of a plan) would be based on the net premium charged by the insurer for such coverage. The annual cost of providing coverage under a noninsured plan (or any noninsured part of a plan) would be based on the costs incurred with respect to the plan, including administrative costs. In lieu of using actual administrative costs, an employer could treat seven percent of the plan's incurred liability for benefit payments as the administrative costs of the plan. A plan would be a noninsured plan to the extent the risk under the plan is not shifted from the employer to an unrelated third party.

The cost of coverage would be determined separately for each separate plan of the employer. Coverage of a group of employees would be considered a separate plan if such coverage differs from the coverage of another group of employees.

The proposal would require that the cost of coverage under the plan be determined in advance of the payroll period. The cost would be redetermined at least once every 12 months, and whenever there are significant changes in the plan's coverage or in the composition of the group of covered employees.

If the actual cost of coverage cannot be determined in advance, reasonable estimates of the cost of coverage would be used. If an estimated cost were determined not to be reasonable, the employer would be liable for the income taxes (at the maximum rate applicable to individuals) and the employment taxes (both the employer's and the employee's share) that would have been paid if the actual cost of coverage had been used. Where an employer makes contributions to a multiemployer plan, the multiemployer plan would be treated as the employer for purposes of determining the cost of coverage and the liability for errors in estimates.

If the cost of coverage fluctuates each year depending on the experience of the employer under the plan, an average annual cost of coverage would be used, based on the average cost for the past three years (adjusted to reflect increases in health insurance costs).

Appropriate nondiscrimination rules would be applied to employer-provided health benefits, regardless of whether employer health plans are self-insured or provided through third parties.

Effective Date

The proposal would generally apply to employer contributions made with respect to payroll periods beginning on or after January 1, 1987. However, an exception would be made for contributions made under a binding contract entered into before the proposal is introduced as legislation, until the earlier of January 1, 1989 or the date such contract expires or is renegotiated.

The proposed dollar limits would apply in 1987, with indexing (based on the Consumer Price Index) starting in 1988.

Analysis

For 1987, the proposed cap on tax-free employee health care would increase the taxable income of only 30 percent of all civilian workers (or approximately one-half of civilian employees who receive some employer-provided insurance). Even for affected taxpayers, only the excess over the $175 family/$70 individual monthly ceilings would be included in gross income.

Most low-income employees would be unaffected by the proposed change because they generally receive employer-provided insurance (if at all) in amounts below the cap. Only about ten percent of those with incomes below the average for all taxpayers would have increased taxable income as a result of the proposal. In contrast, approximately 40 percent of the wealthiest one-fifth of all taxpayers would have additional taxable income as a result of the proposal, with 60 percent of the additional tax liability borne by that group. A small number of low-income workers now receive an extremely large proportion of their compensation in the form of health insurance; the impact on those workers, however, would be mitigated by the proposed increases in the personal exemptions and zero bracket amounts.

Table 2 shows how the proposal would affect a taxpayer whose compensation costs his employer $35,000, including $2,400 of employer contributions for health insurance (Taxpayer A in Table 1), assuming no other changes in current law. This employee would only pay tax on the $25 per month by which the employer's contributions exceed the ceiling. Thus, even with the proposed cap, this employee would still pay far less tax than an employee whose compensation costs his employer the same $35,000 but who received all his compensation in the form of cash. However, the subsidy would be reduced from $809 to

$707. Each dollar of the employer-provided insurance would now cost the employee an average of $0.71, just slightly more than the $0.66 under current law.

More importantly, however, each additional dollar of insurance above the $2,100 ceiling would cost a full dollar. At the margin, the employee with employer contributions above the ceiling would pay the full cost of the insurance and would therefore be more cost-conscious. As a result, the proposal would help contain escalating medical costs by spurring interest in health maintenance organizations, private cost review programs, copayments and other market-oriented cost containment approaches. Moreover, these strong incentives for cost control would be obtained without undermining the incentives for employer-provided insurance that guarantees essential health care and protects against the risk of serious injury or illness.

Table 2 illustrates the impact of implementing the health cap with no other changes in current law. Other provisions of the Treasury Department proposals would lower individual tax rates and thereby reduce the effective subsidy for employer-provided health insurance. Under these other proposals, the taxpayer discussed above would be in the 15 percent income tax bracket, and the average cost of $2,400 of employer-provided health insurance would rise to $0.71 per dollar without the health cap and $0.74 with the cap.

Table 2

Impact of a Cap on Excludable Employer Contributions for Health Insurance 1/

	Taxpayer with $2,400 of Employer-Provided Health Insurance	
	Current Law	Proposed Law
Total Employer Cost	$35,000	$35,000
Non-Taxable Employer-Provided Health Insurance	$ 2,400	$ 2,100
Employer Social Security Tax	$ 2,147	$ 2,167
Cash Wages Plus Taxable Health Insurance	$30,453	$30,733
Employee Income Tax	$ 2,996	$ 3,058
Employee Social Security Tax	$ 2,147	$ 2,167
After-Tax Income Plus Value of Health Insurance	$27,710	$27,610
Cost of $2,400 of Health Insurance	$ 1,591	$ 1,692
Average Cost per $1 of Health Insurance	$ 0.66	$ 0.71
Cost of each $1 of Health Insurance above $2,100	$ 0.64	$ 1.00

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November 30, 1984

1/ Assumes no other change in current law.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED GROUP TERM LIFE INSURANCE

General Explanation

Chapter 3.02

Current Law

The cost of employer-provided group-term life insurance is excluded from an employee's income to the extent it is not in excess of the sum of (1) the cost of $50,000 of such insurance, and (2) the amount paid by the employee for such insurance. For purposes of the exclusion, the cost of group-term life insurance is determined on the basis of uniform premiums established in Treasury regulations. The cost of certain kinds of group-term life insurance is excluded without limit, including, for example, insurance on a former employee who is disabled and insurance under which the employer is directly or indirectly the beneficiary. The exclusion is not available to self-employed individuals.

Reasons for Change

The exclusion of group-term life insurance from income causes significant inequities among taxpayers. Taxpayers receiving group-term life insurance through an employer-sponsored plan effectively purchase such insurance with pre-tax dollars, whereas taxpayers not covered by an employer plan must use after-tax dollars to acquire the same insurance. Thus, two taxpayers with identical real incomes may pay different amounts in income taxes. Moreover, even among taxpayers covered by employer plans, the exclusion of group-term life insurance favors high-bracket over low-bracket taxpayers. For a taxpayer in a 50 percent marginal tax bracket, the exclusion provides a 50 percent savings in the cost of insurance; on the other hand, for a 20 percent bracket taxpayer, the exclusion produces only a 20 percent savings.

The group-term life insurance exclusion lowers the after-tax cost of term life insurance and thus encourages employees to request and employers to provide more insurance than the employees would be willing to pay for on their own. Because this subsidy for term life insurance is provided through the tax system, its actual cost to society is difficult to control or monitor. As with other fringe benefit exclusions, the group-term life insurance exclusion also narrows the tax base and thus causes higher than necessary marginal tax rates.

Proposal

The exclusion of group-term life insurance from income would be repealed. Group-term life insurance provided by an employer would be taxable under the same general principles that apply to other employer-provided fringe benefits.

Effective Date

The repeal generally would be effective for group-term life insurance provided on or after January 1, 1987. However, the exclusion would continue for such insurance if provided under a binding contract entered into prior to the date this proposal is introduced as legislation, until the earlier of January 1, 1989 or the date such contract expires or is renegotiated.

Analysis

Almost one-half of all families receive some employer-provided group-term life insurance. Such insurance accounts for approximately 40 percent of the value of all life insurance in force. Given the lower rates available through group-term insurance, most employers are expected to continue to make such insurance available.

REPEAL $5,000 EXCLUSION FOR EMPLOYER-PROVIDED DEATH BENEFITS

General Explanation

Chapter 3.03

Current Law

Death benefits paid by an employer to the estate or beneficiaries of a deceased employee are excluded from the recipient's income. The maximum amount that may be excluded from income with respect to any employee is $5,000. Accordingly, an allocation of this exclusion is required if multiple beneficiaries receive, in the aggregate, more than $5,000. Except with respect to certain distributions from or under qualified plans, the exclusion does not apply to self-employed individuals.

In addition to the statutory exclusion, some courts have permitted taxpayers to exclude from income payments from a decedent's employer in excess of $5,000. The rationale of these cases is that the employer's payment to the decedent's estate or beneficiary constitutes a gift rather than compensation. Such "gifts" are not subject to the $5,000 limitation.

Reasons for Change

The exclusion of certain death benefits from income creates an artificial preference for compensation to be paid in this form. The exclusion of such benefits from the tax base causes the tax rates on other compensation to increase. Moreover, the exclusion is unfair because it is not available to all taxpayers (such as self-employed individuals).

Finally, confusion exists under present law as to whether a payment by an employer to a deceased employee's family constitutes a death benefit subject to the $5,000 limitation or a fully excludable gift. Treatment of such a payment as a gift is contrary to economic reality and leads to different tax treatment on similar facts.

Proposal

The proposal would repeal the $5,000 exclusion for employer-furnished death benefits. Any amount paid by or on behalf of an employer by reason of the death of an employee to the estate or a family member or other beneficiary of the decedent would be characterized as a taxable death benefit rather than as an excludable gift.

Effective Date

The repeal would be effective for benefits paid due to deaths occurring on or after January 1, 1986. The exclusion would continue, however, for amounts paid under a binding, written employment contract entered into prior to the date this proposal is introduced as legislation, until the earlier of January 1, 1989 or the date such contract expires or is renegotiated.

Analysis

Approximately $400 million of employer-provided death benefits are excluded from income under current law. As with all exclusions, the tax benefit per dollar of the death benefit exclusion increases with the recipient's tax bracket. Thus, the exclusion provides the greatest assistance to high-income taxpayers, who are also more likely to receive such benefits than low-income taxpayers.

Moreover, the Treasury Department proposals would repeal the current exclusion from income of employer-provided group-term life insurance. Absent repeal of the death benefit exclusion, the taxation of employer-provided group-term life insurance would encourage employers to recharacterize life insurance as an excludable death benefit.

Finally, a specific provision that payments from an employer to a deceased employee's estate or family do not constitute gifts would simplify current law and also reduce the unfairness created by current law where similar facts may lead to different tax results.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED LEGAL SERVICES

General Explanation

Chapter 3.04

Current Law

Gross income of an employee does not include personal legal services provided by an employer under a qualified group legal services plan nor does it include amounts contributed by an employer on behalf of an employee under such a plan. A qualified group legal services plan must satisfy certain statutory rules, including provisions regarding nondiscrimination in eligibility, contributions, and benefits.

The group legal services exclusion is currently scheduled to expire for taxable years ending after December 31, 1985.

Reasons for Change

The exclusion from income of employer-provided group legal services encourages overconsumption of legal services by permiting employees to purchase them with pre-tax dollars. The exclusion is also unfair because it is not available to all taxpayers and, where available, is of greater benefit to high-income taxpayers. Finally, by encouraging employees to take more of their compensation in this untaxed form, the exclusion narrows the tax base and thus places upward pressure on marginal tax rates.

Proposal

The group legal exclusion would be allowed to expire.

Effective Date

Taxpayers have had notice that the group legal services exclusion would expire. It would be allowed to expire by its own terms.

Analysis

Expiration of the exclusion for group legal services will allow a market for such services to develop without tax-induced distortions.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED DEPENDENT CARE SERVICES

General Explanation

Chapter 3.05

Current Law

Dependent care assistance paid for or provided by an employer is excluded from the income of an employee if the assistance is provided under a plan meeting certain nondiscrimination and other requirements. Dependent care assistance is defined to mean the payment for, or provision of, household services for, or care of, an eligible dependent where such assistance enables the employee to be gainfully employed. Eligible dependents include (1) a dependent of the employee under the age of 15 with respect to whom the employee is entitled to a personal exemption, and (2) a dependent or spouse of the employee who is physically or mentally incapable of caring for himself. If the employee is not married, the amount excluded may not exceed the employee's earned income. If the employee is married, the amount excluded may not exceed the lesser of the earned income of the employee or of his spouse.

Dependent care expenses incurred by an individual maintaining a household are eligible for a tax credit. The credit equals the applicable percentage of amounts paid (up to the limits described below) for dependent care assistance. The applicable percentage is 30 percent reduced by one percentage point (but not below 20 percent) for each $2,000 by which the taxpayer's adjusted gross income exceeds $10,000. The amount subject to the credit in any year may not exceed $2,400 for one eligible dependent, or $4,800 for two or more eligible dependents. The amounts subject to the credit also may not exceed the employee's earned income or, in the case of a married couple, the lesser of the earned income of the employee or of the employee's spouse.

Dependent care assistance that is paid or provided by an employer and excluded from income is not eligible for the dependent care credit.

Reasons for Change

Dependent care expenses that enable a taxpayer to be gainfully employed constitute, at least in part, a business expense properly deductible from income. Although current law gives some recognition to the business component of dependent care expenses, the treatment of such expenses depends on whether they are financed by an employer or by the individual taxpayer. Dependent care services provided by an employer are excluded from income. Taxpayers who pay for such services themselves are eligible for a tax credit, which may be worth more or less to the taxpayer than a comparable exclusion.

There is no basis for the different tax treatment of employer-provided and individual-financed dependent care. In order to rationalize tax treatment of dependent care expenses, a deduction for certain dependent care expenditures should be available to all taxpayers. A proposal to that effect is presented in Chapter 2.05. Allowance of a deduction for dependent care expenses makes an exclusion of employer-provided dependent care inappropriate and unnecessary.

Finally, the exclusion makes it difficult to enforce the caps under the current credit (or the proposed dependent care deduction). Without repeal, expenses far above the caps (for very expensive child care) could be unfairly excluded in some cases.

Proposal

The exclusion for employer-provided dependent care would be repealed.

Effective Date

The repeal would be effective for taxable years beginning on or after January 1, 1986. There would be an exception, however, for assistance provided under a binding contract entered into prior to the date this proposal is introduced as legislation, until the earlier of January 1, 1989 or the date such contract expires or is renegotiated.

Analysis

Approximately 400 private employers, about three-quarters of which are hospitals, provide on-site dependent care centers. A few others provide care through vouchers, and a 1984 survey found 60 major employers offering dependent care as part of a cafeteria plan. In addition, the military provides subsidized care to at least 47,000 children.

Further growth in employer-provided dependent care assistance is expected, under current law, through cafeteria plans. Except in certain special cases (such as hospitals), these programs provide benefits to only a small fraction of employees, and therefore do not receive broad-based employee support outside of cafeteria plans. The Treasury Department proposals would repeal the exclusion of cafeteria plans. See Chapter 3.08.

Repeal of the dependent care exclusion should not adversely affect the income tax liabilities of most employees receiving such assistance since an offsetting deduction for dependent care expenditures would be available. See Chapter 2.05. Employers would still have an incentive to provide on-site dependent care services, or to contract for their provision, where they promote employee convenience or result in cost savings.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED COMMUTING SERVICES

General Explanation

Chapter 3.06

Current Law

The value of employer-provided commuting transportation is excluded from the income of employees if the transportation services are provided under a nondiscriminatory plan using vehicles that meet size and usage requirements. The exclusion is not available to self-employed individuals and is scheduled to expire for taxable years beginning after December 31, 1985.

Reasons for Change

As with most other fringe benefit exclusions, the exclusion of qualified transportation services from employee income is economically inefficient, inconsistent with horizontal equity principles, and a contributing factor in the high marginal rates of tax on taxable income. The qualified transportation exclusion is an inefficient mechanism to promote energy conservation since it targets only one form of group transportation, employer-provided van pools. This may cause taxpayers to reject possibly more effective but non-subsidized transportation alternatives. The exclusion is unfair because it is not available to all individuals and because, where available, it provides a greater benefit to high-bracket taxpayers.

Proposal

The exclusion from gross income of the value of employer-provided commuting transportation would be allowed to expire.

Effective Date

Taxpayers have had notice of the scheduled expiration of the van-pooling exclusion for taxable years beginning after December 31, 1985. It would be allowed to expire according to its terms.

Analysis

Expiration of the van-pooling exclusion will eliminate this unnecessary distortion.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

General Explanation

Chapter 3.07

Current Law

Up to $5,000 of employer-provided educational assistance is excluded from an employee's income if provided under a nondiscriminatory plan. Employers may either provide educational assistance directly or reimburse the employee for expenses. The education may not involve sports, games, or hobbies, and the assistance may not include payment for meals, lodging, transportation, or certain supplies.

The exclusion is currently scheduled to expire for taxable years beginning after December 31, 1985.

Educational expenses generally qualify as deductible business expenses if they are "job-related." Educational expenses which are not job-related and are not otherwise deductible are treated as non-deductible personal expenditures. Under current regulations, to be job-related, education must either: (1) maintain or improve skills required by the individual in his employment or other trade or business, or (2) meet the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation.

An employee may not deduct education expenses that are reimbursed by the employer if the reimbursement is excluded from income as employer-provided educational assistance.

Reasons for Change

Education is a national priority deserving broad public and private support. The exclusion from income of employer-provided educational assistance, however, is not an appropriate means of extending that support. The benefits of the exclusion are not fairly distributed since it is available only to employees in qualified plans. Even within the group of eligible employees, the exclusion is of greater value to high-income taxpayers. Finally, as an incentive provided through the Code, the educational assistance exclusion avoids the regular oversight and administrative controls that apply to direct budget expenditures.

Proposal

The exclusion of employer-provided educational assistance would be allowed to expire.

Effective Date

Taxpayers have had notice of the exclusion's expiration for taxable years beginning on or after January 1, 1986. It would be allowed to expire pursuant to its terms.

Analysis

Job-related educational expenditures are already deductible as ordinary and necessary business expenses, whether employer-provided or not. In general, repeal of the exclusion for employer-provided educational assistance would only affect those for whom the expense would not be deductible as a job-related expense; other employees would be able to offset the income with a corresponding business expense deduction.

There is no reason to believe that the education assistance exclusion of current law benefits primarily the groups for which it was intended -- minorities and the unskilled. The tax benefit is greatest for high-bracket taxpayers, and participation in adult education by those groups is relatively low.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED CAFETERIA PLANS

General Explanation

Chapter 3.08

Current Law

No amount may be included in the income of a participant in a "cafeteria plan" solely because the participant may choose among the benefits available through the plan. A cafeteria plan is a plan established by an employer for some or all of its employees under which employees may choose between two or more benefits consisting of cash and "statutory nontaxable benefits." The phrase statutory nontaxable benefits includes certain welfare benefits such as accident or health insurance and dependent care assistance. Cafeteria plan benefits may also include certain taxable benefits, including taxable group-term life insurance in excess of $50,000, and vacation days, if participants cannot cash out or use in a subsequent plan year any vacation days remaining unused at the end of the year.

The cafeteria plan exception to general constructive receipt rules does not apply to "highly compensated participants" if the plan discriminates in favor of "highly compensated individuals" as to eligibility or in favor of highly compensated participants as to contributions and benefits. In addition, the exception is not available to a "key employee" if the statutory nontaxable benefits (without regard to taxable group-term life insurance) provided to key employees exceed 25 percent of the aggregate of such benefits provided to all employees.

Reasons for Change

The cafeteria plan rules depart from general tax accounting principles, add complexity to the tax law, undermine the coverage rules generally applicable to nontaxable fringe benefits, and facilitate the provision of increased amounts of compensation as nontaxable fringe benefits. In the absence of the cafeteria plan rules, the "constructive receipt" doctrine would require that an employee with the right to choose between cash compensation and some nontaxable benefit be treated for tax purposes as having received the cash even though he chooses to receive the nontaxable benefit. In overriding the constructive receipt doctrine, the cafeteria plan rules disregard the fact that an employee who is entitled to receive cash but instead elects an in-kind benefit is in the same pre-tax economic position as a taxpayer who receives cash and purchases the benefit directly. The cafeteria plan rules result in different tax treatment of these similarly situated individuals.

By allowing employees to pick and choose among nontaxable fringe benefits, the cafeteria plan rules eliminate employee disagreement over the desirability of particular benefits as a limiting factor on the availability of such benefits. The rules thus effectively increase the percentage of compensation that employees receive in nontaxable forms.

The cafeteria plan rules also undermine the coverage and nondiscrimination requirements for statutory fringe benefits by permitting individual employees to decide whether they wish to receive a particular benefit. Generally, the rationale for excluding an employer-provided benefit from employees' income is to encourage the broadest extension of the particular benefit to employees on a nondiscriminatory basis. The cafeteria plan rules undercut this rationale, since they permit individual employees to elect cash over the benefit without affecting the tax treatment of other employees. In effect, the tax benefits are made available without regard to whether all employees receive the particular benefit on a broad, nondiscriminatory basis.

Proposal

The cafeteria plan exclusion would be repealed.

Effective Date

The repeal would generally be effective on and after January 1, 1986. There would be an exception, however, for cafeteria plans in existence after such date under a binding contract entered into prior to the date this proposal is introduced as legislation, until the earlier of January 1, 1989 or the date such contract expires or is renegotiated.

Analysis

If current law regarding fringe benefits remains unchanged, rapid growth in cafeteria plans is expected, further eroding the tax base. It is estimated that the number of employees covered under such plans (less than 1,000,000 in 1983) would rise to 25,000,000 by 1989. This would mean a rapid increase in the consumption of employer-provided nontaxable fringe benefits. The Treasury Department proposals, however, would repeal the exclusion of most statutory fringe benefits from income. With fewer nontaxable fringe benefits available for inclusion in cafeteria plans, the significance of cafeteria plan selectivity would be proportionately diminished.

REPEAL SPECIAL TREATMENT OF INCENTIVE STOCK OPTIONS

General Explanation

Chapter 3.09

Current Law

In general, a stock option granted by a corporate employer to an employee is subject to tax under statutorily prescribed rules applying to transfers of property in connection with the performance of services. Under these rules, if an employee receives an option with a readily ascertainable fair market value, such value (less the price paid for the option, if any) constitutes ordinary income to the employee when the employee becomes substantially vested in the option (i.e., the option either becomes transferable or ceases to be subject to a substantial risk of forfeiture). If an employee receives an option that does not have a readily ascertainable value, the option is not taxable to the employee; instead the employee is taxable on the stock received upon exercise of the option when the employee becomes substantially vested in such stock. Ordinary compensation income is recognized at that time equal to the difference between the option price and the value of the stock.

Current law provides an exception to the above general rules for certain "incentive stock options" granted to employees. If a stock option qualifies as an incentive stock option, the employee will realize no income upon receipt or exercise of the option. Moreover, gain upon sale of the stock acquired by exercise of the option will be taxed at capital gain rates, provided that (i) the employee does not transfer the stock within two years after the option is granted, and (ii) the employee holds the stock itself for one year. An employer may not claim a deduction with respect to an incentive stock option or stock transferred pursuant to such an option.

To qualify as an incentive stock option, the option must be granted pursuant to a plan approved by the corporation's shareholders. The plan must provide that an employee cannot be granted, in any one year, options to purchase more than $100,000 of stock plus any available carryover amount. An incentive stock option must carry an option price equal to the fair market value of the stock at the time the option is granted. An incentive stock option cannot be exercisable more than ten years from the date of its grant, and cannot be transferable (other than at death). In addition, an incentive stock option cannot be exercised while there is outstanding any other incentive stock option granted to the employee at an earlier date entitling the employee to purchase stock in the employer corporation, its parent, its subsidiaries, or a predecessor of any such corporation. Finally, unless certain special requirements are met, incentive stock options generally cannot be granted to employees who own, at the time of grant, stock possessing more than ten percent of the total combined voting power of the employer corporation or its parent or subsidiaries.

Reasons for Change

The special rules applicable to incentive stock options permit corporate employers to provide tax-preferred compensation to management personnel and other key employees. Thus, compensation attributable to incentive stock options not only is eligible for preferential capital gain treatment, but its inclusion in income is deferred from receipt or exercise of the option to the time the stock acquired pursuant to the option is sold. Although employers receive no deduction with respect to incentive stock options, differences in the marginal tax rates of corporations and their key employees would ordinarily produce a net tax savings.

The purpose of the incentive stock option provisions is to enable corporations to attract and retain key management employees. There is no substantial evidence, however, that stock options in themselves are more attractive to key employees than cash or other forms of compensation of equivalent value. Instead, the incentive feature of stock options under current law is their highly favorable tax treatment.

Because of the tax treatment of incentive stock options, recipients of such options are permitted to understate their income for tax purposes and thus to pay less tax than others in the same economic position. This Federal subsidy for typically affluent taxpayers would never survive as a direct budget expenditure, but depends upon concealment in the tax law. It is unfair not only to employees who do not receive such tax-preferred compensation, but also to the noncorporate employers that cannot issue stock options.

Proposal

The incentive stock option provisions would be repealed. All employer-provided stock options would thus be taxed under the general rules applicable to transfers of property in connection with the performance of services.

Effective Date

The proposal would apply to options granted on or after January 1, 1986, except options granted prior to the date the proposal is introduced as legislation.

Analysis

The impact of repeal would fall largely on the small class of key management employees who ordinarily participate in stock option plans. Since the Treasury Department proposals would eliminate the current preferential tax rate for long-term capital gain, see Ch. 9.01, repeal of the incentive stock option rules would only affect the time at which compensation income was reported.

REPEAL TAX EXEMPTION FOR VEBAs, SUB TRUSTS AND BLACK LUNG TRUSTS

General Explanation

Chapter 3.10

Current Law

In general, the year in which an employer may deduct compensation provided to its employees, either in the form of cash or welfare benefits, corresponds to the year in which the employees include (or, but for an exclusion, would include) the compensation in income. In addition, if an employer prefunds its obligations to pay future employee compensation, income earned on the amounts set aside for that purpose is taxable to the employer.

In certain circumstances, the tax law has permitted an employer more favorable treatment for amounts set aside to prefund future compensation obligations. In such cases, the employer has been allowed a current deduction for contributions to a reserve for future compensation, and the reserve has been permitted to grow on a tax-exempt basis. With respect to compensation paid in cash, this favorable treatment generally has been available only with respect to profit-sharing and pension plans that comply with various qualification rules, such as nondiscrimination rules, minimum standards relating to participation, vesting, benefit accrual, and funding, and annual limits on contributions and benefits. With respect to compensation provided in the form of welfare benefits, the favorable tax treatment has been available for contributions to welfare benefit funds, such as voluntary employees' beneficiary associations (VEBAs), supplemental unemployment compensation benefit (SUB) trusts, and black lung trusts. Thus, subject to certain limitations, employers are able to deduct currently contributions to VEBAs, SUB trusts, and black lung trusts which fund future employee benefits such as health care and unemployment or disability compensation. In general, investment income earned by these associations and trusts is exempt from tax. Unlike qualified pension plans, VEBAs, SUB trusts and black lung trusts are not subject to mimimum standards for funding, participation and benefit accrual, or to annual limits on benefits.

Beginning in 1986, new rules adopted in the Tax Reform Act of 1984 will govern an employer's deduction for contributions to VEBAs, SUB trusts, and other welfare benefit funds and will limit the extent to which the income of such associations, trusts, and funds will be tax-exempt. (Black lung trusts are not affected by the new rules.) Under the new rules, amounts set aside to provide post-retirement life insurance up to $50,000 to retired employees and to make disability payments to disabled employees will be permitted to continue to grow on a tax-exempt basis. In addition, amounts set aside in one year to cover claims incurred during that year will be permitted to grow on a tax-exempt basis. Finally, subject to various limits, amounts still may be set aside on a tax-exempt basis to provide for future unemployment compensation.

Reasons for Change

The tax benefit of tax-exempt growth for amounts set aside to fund deferred compensation should generally not be available outside of the qualified retirement plan area. Although the rules adopted in the Tax Reform Act of 1984 will limit the type and levels of benefits for which an employer may prefund on a tax-favored basis, the advantage of tax-exempt growth remains for certain benefits within the specified limits. This exemption of investment income from tax effectively shifts a portion of the cost of employee compensation to the general public.

In addition, continuation of the exemption would be inconsistent with the tax treatment of reserves for welfare benefits under a policy with an insurance company. The Treasury Department proposals include taxation of the income on reserves held by casualty insurance companies. See Ch. 12.05. In order not to provide more favorable tax treatment to self-insured benefit arrangements than to insured arrangements, the income earned by VEBAs, SUB trusts, and black lung trusts should similarly be subject to tax.

Proposal

The tax exemption for VEBAs, SUB trusts, and black lung trusts would be repealed.

Effective Date

The repeal would apply for taxable years of the VEBAs, SUB trusts, and black lung trusts beginning on or after January 1, 1986.

Analysis

Although the proposal would subject the income of VEBAs, SUB trusts, and black lung trusts to tax, the existing rules governing employer deductions for contributions to these associations and trusts would not be altered. Thus, to the extent permitted under current law, an employer would be able to continue to deduct contributions to these organizations.

REPEAL EXCLUSION FOR EMPLOYEE AWARDS

General Explanation

Chapter 3.11

Current Law

Gifts are excluded from the gross income of the donee. Whether an employer's award to an employee constitutes taxable compensation or a gift excludable from gross income depends upon the facts and circumstances surrounding the award.

If an employee award is excludable from income as a gift, the amount that can be deducted by the employer is limited by statute. In general, the cost of a gift of an item of tangible personal property awarded to an employee by reason of length of service, productivity or safety achievement may not be deducted by the employer to the extent that it exceeds $400. In the case of an award made under a permanent, written plan which does not discriminate in favor of officers, shareholders or highly compensated employees, gifts of items with a cost up to $1600 may be deducted, provided that the average cost of all items awarded under all such plans of the employer does not exceed $400.

The fact that an award does not exceed the dollar limitations on deductions has no bearing on whether the award constitutes taxable compensation to the employee; in all cases that issue depends on the facts and circumstances surrounding the award. Nevertheless, many taxpayers take the position that if the dollar limitations are not exceeded, the award automatically constitutes a gift and is excludable from the employee's income.

Reasons for Change

A gift for tax purposes is a transfer of property or money attributable to detached and disinterested generosity, motivated by affection, respect, admiration, or charity. The on-going business relationship between an employer and employee is generally inconsistent with the disinterest necessary to establish a gift for tax purposes. Moreover, in the unusual circumstances where an employee award truly has no business motivation, it cannot consistently be deducted as an ordinary and necessary expense of the employer's business.

Current law not only allows employee awards to be characterized as gifts but provides a tax incentive for such characterization. The amount of an employee award treated as a gift is excluded from the income of the employee, and the employer may nevertheless deduct the award to the extent it does not exceed certain dollar limits. Even to the extent an award exceeds those limits, gift characterization produces a net tax advantage if the employee's marginal tax rate exceeds that of the employer.

Current law also generates substantial administrative costs and complexity by requiring the characterization of employee awards to turn on the facts and circumstances of each particular case. The dedication of Internal Revenue Service and taxpayer resources to this issue is inappropriate, since relatively few employee awards represent true gifts and since the amounts involved are frequently not substantial.

Proposal

Gift treatment would generally be denied for all employee awards of tangible personal property. Such awards would ordinarily be treated as taxable compensation, but in appropriate circumstances would also be subject to dividend or other non-gift characterization. It is anticipated that a de minimis award of tangible personal property would be excludable by the employee under rules of current law concerning de minimis fringe benefits.

Effective Date

The proposal would be effective for awards made on or after January 1, 1986.

Analysis

Available data concerning employee awards of tangible personal property is incomplete. Surveys indicate that businesses made gifts to employees totalling approximately $400 million in 1983. It is unclear what portion of these gifts were in the form of tangible personal property; however, the majority of these gifts were less than $25 in value. Less than ten percent of all employees are covered by an employer plan for such benefits. Thus, the proposal would affect few employees and would promote horizontal equity.

REPEAL EXCLUSIONS FOR MILITARY ALLOWANCES

General Explanation

Chapter 3.12

Current Law

Most military personnel and members of other uniformed services receive tax-free cash allowances for quarters and subsistence in addition to their taxable basic pay. The exclusion from income of military housing and subsistence allowances stems from an early decision of the courts and is now codified in Treasury regulations and Federal statutes governing military compensation.

Compensation received by members of the armed forces while serving in a combat zone or while hospitalized for combat-related injuries is excluded from income. In the case of a commissioned officer, the amount of this exclusion is limited to $500 per month. Current law also provides for complete forgiveness of income tax for servicemen dying while in active service in a combat zone or as a result of wounds, disease, or injury incurred while so serving. The forgiveness applies to the year of death and prior years ending on or after the serviceman's first day of service in a combat zone. A similar forgiveness of income tax is available to military and civilian employees of the United States who die as a result of wounds or injury incurred outside the United States in a terroristic or military action.

Amounts received by a member of the uniformed services as a pension, annuity or similar allowance for combat-related injuries or a veteran's disability also are excluded from income. A further exclusion is provided for mustering-out payments to members of the armed services.

Reasons for Change

Military personnel should be compensated fairly for their work and sacrifices. It is especially appropriate that the nation provide for those who have been injured or killed in the service of their country, as well as for their survivors. The provision of a portion of military compensation in the form of tax benefits, however, interferes with the budget process. Decisions concerning the form and amount of direct military compensation cannot be made intelligently unless the full revenue costs are understood. Current tax exemptions disguise these costs.

The provision of a portion of compensation in the form of tax benefits is not a fair substitute for additional taxable compensation. The tax benefit of an exclusion from income or a forgiveness of tax is disproportionately greater for those with higher incomes and higher marginal tax rates. The current forms of tax relief for the military thus discriminate in favor of high-income over low-income members of the military. Tax revenue lost as a result of tax relief for the military reduces the level of direct compensation that the nation can afford to pay. Thus, the cost of tax relief is borne by all members of the military, even though it disproportionately benefits those with higher incomes. Increasing basic pay and other direct compensation is the fairest method of compensating military personnel.

Proposal

Compensation received by members of the uniformed services generally would be subject to Federal income tax under the same principles applicable to civilian employees. Thus, cash allowances for quarters and subsistence would be includible in gross income. In-kind allowances also would be subject to taxation, but meals and lodging provided on military premises would be excluded from income if the convenience of the employer standard of current law is satisfied.

The exclusion from income of combat-related compensation would be repealed. The exclusion from income of allowances for combat-related injuries and disablility compensation also would be repealed. However, such allowances, as with disability income of civilian workers generally, would be eligible for the credit for the elderly, blind and disabled. See Ch. 2.02. Finally, the current forgiveness of income tax for servicemen and other employees of the United States dying as a result of terroristic or military action outside the United States would be repealed, along with the exclusion for mustering-out pay.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1987.

Analysis

It is expected that, through the regular budget process, military pay and allowance schedules would be adjusted to reflect the taxation of previously tax-free allowances. Thus, on average, servicemen and women would not suffer a reduction in after-tax compensation.

The proposed changes generally would make the taxation of military compensation equivalent to the taxation of compensation in other areas in the economy. Thus, regular cash and in-kind compensation of members of the military would be taxable under the same general principles that apply to civilian employees. In addition, similar treatment of injury and disability wage-based compensation would be provided for military and civilian employees. Thus, the current exclusion for military disability compensation would be repealed, consistent with the Treasury Department proposal to include civilian worker's compensation in income. See Chapter 3.14.

The delayed effective date should provide ample time for adjustments in military compensation.

REPEAL EXCLUSION FOR PARSONAGE ALLOWANCES

General Explanation

Chapter 3.13

Current Law

Employer-provided housing is generally taxable compensation to an employee unless the housing is on the business premises of the employer, must be accepted as a condition of employment, and is provided for the convenience of the employer. Under current law, however, a minister does not include in his gross income the rental value of a home furnished as part of his compensation. Cash rental allowances, to the extent used to rent or obtain a home, also are excluded from a minister's income.

Reasons for Change

The exclusion from income of parsonage allowances departs from generally applicable income measurement principles, with the result that ministers pay less tax than other taxpayers with the same or even smaller economic incomes. Thus, a minister with a salary of $18,000 and a $6,000 cash housing allowance is in the same economic position and has the same ability to pay tax as a taxpayer (such as a teacher) earning $24,000 in taxable income and spending $6,000 on housing. The tax liability of the minister is considerably less, however, due to the current exclusion from taxable income of the parsonage allowance. Further, as with other deviations from income measurement principles, the exclusion of parsonage allowances narrows the tax base and places upward pressure on marginal tax rates.

There is no evidence that the financial circumstances of ministers justify special tax treatment. The average minister's compensation is low compared to other professions, but not compared to taxpayers in general. Moreover, the tax benefit of the exclusion provides a disproportionately greater benefit to relatively affluent ministers, due to the higher marginal tax rates applicable to their incomes.

Proposal

The income exclusion for parsonage allowances would be repealed. Ministers would include in their gross income any cash housing allowance. The fair market rental value of employer-provided housing would also be taxable unless it met the convenience of the employer standard of current law.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1987.

Analysis

Repeal of the exclusion for parsonage allowances would reduce the after-tax income of the more than 140,000 ministers who receive housing or housing allowances if no compensatory adjustment in salary is made. Current salary levels for ministers often reflect the favorable treatment of parsonage allowances. It may be expected that, in many cases, salaries would be adjusted to take account of repeal of the exclusion for parsonage allowances, so that ministers' after-tax incomes would not be significantly affected.

In some cases, however, particularly where the work of a minister is identical to that of a non-minister (such as teaching in religious schools), no compensating increase in salary is likely. These cases, however, provide the clearest examples of how current law provides different treatment for taxpayers with the same economic income.

Taxing cash housing allowances is administratively easy. Taxing employer-provided housing, however, will require determination of whether the housing may be excluded from income under the current law convenience of the employer standard, and, if not, an estimation of the fair market rental value of such housing. These determinations involve some administrative costs and taxpayer burdens, but they are no different than those required in other cases where employees receive housing or other taxable in-kind compensation from their employers.

The delayed effective date should provide sufficient time for readjustments of compensation arrangements in which ministers currently receive tax-free housing either in kind or through rental allowances.